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STAR - Q3 2016 iStar Inc Earnings Call

EVENT DATE/TIME: NOVEMBER 03, 2016 / 2:00PM GMT

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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by and good day and welcome to iStar's third-quarter 2016 earnings conference call.

(Operator Instructions)

As a reminder, today's conference is being recorded. At this time for opening remarks and introductions I would like to turn the conference over to Mr. Jason Fooks, Vice President of Investor Relations and Marketing. Please go ahead, sir.

Jason Fooks - *iStar Financial Inc. - VP, IR & Marketing*

Thank you, John, and good morning everyone. Thank you for joining us today to review iStar's third-quarter 2016 earnings report. With me today are Jay Sugarman, Chairman and Chief Executive Officer, and Geoff Jervis, our Chief Operating Officer and Chief Financial Officer.

This morning's call is being webcast on our website at iStar.com in the investors section. There will be a replay of the call beginning at 12:30 p.m. Eastern Time today. Dial-in for the replay is 1-800-475-6701 with the confirmation code of 403997.

Before I turn the call over to Jay, I'd like to remind everyone that statements in this earnings call which are not historical facts will be forward-looking. iStar's actual results may differ materially from these forward-looking statements and the risk factors that could cause these differences are detailed in our SEC reports and in our investor presentation which is posted on our website. iStar disclaims any intent or obligation to update these forward-looking statements except as especially required by law.

Now I'd like to turn the call over to iStar's Chairman and CEO Jay Sugarman. Jay?

Jay Sugarman - *iStar Financial Inc. - Chairman & CEO*

Thanks, Jason and thanks everyone for being with us this morning. The third quarter was an active one for us as we continued to seek attractive new investments and realize on the value of assets we have worked hard to redevelop and position for sale. This increased activity in the legacy book should continue into 2017 and we've provided some additional information in the press release to try to organize some of the moving pieces and highlight areas of success and areas still of concern.

Keys for the quarter included monetizing a number of legacy assets, adding new assets to our net lease JV portfolio, expanding our capital available for new investments and generating strong returns on assets that have reached stabilization. This led to strong earnings and substantial liquidity, and positions us to retire two convertible debt issues in November to further reduce our diluted share count.

Leading the quarter's positive outcomes was the lease-up and refinancing of 1000 South Clark Street in Chicago, a 469 unit ground-up Class A multifamily asset that we developed in a joint venture on land we had previously foreclosed on. Built over the last 18 months, the asset was refinanced as it nears stabilization, generating a $16 million gain to iStar while leaving us with a valuable 50% interest in the equity that now has zero basis on our books.

It was also a strong quarter for net lease investments with two new commitments totaling $218 million going into our JV with our sovereign wealth fund partner. One of these was $168 million off-market build to suit with an investment grade tenant that will be brought online over the next 24 months while the other is a headquarters complex outside San Francisco that has the potential to grow larger over time.

We also continue to stabilize and sell down assets in the operating property portfolio and refine our net lease portfolio. This quarter we sold two office buildings in South Florida for just under $60 million in proceeds and a group of buildings in a small strip center in Northern California for $87 million for combined gains approaching $30 million.

Over in the land portfolio things are moving, though we are still waiting for various final approvals to enable us to turn these assets and our years of hard work into cash and earnings. On the West Coast we have closed on the second of our two commercial parcels in our San Jose project Great Oaks and expect sales of the residential parcels in that project to take place in 2017 along with the sale of all of our planning areas in our Highpark project in Southern California. This is one of the largest ready-to-build parcels of land in Los Angeles County directly adjacent to Rancho Palos Verdes. It's a valuable piece of land that we continue to receive inquiries from multiple homebuilders on.

On the East Coast we sold the first of multiple parcels we owned in Coney Island and continue working with a local partner and the city to execute a more comprehensive strategy for the oceanfront parcel we own adjacent to our new Ford Amphitheater where, by the way, we hosted over 40 concerts this summer. Progress was short-circuited in Long Beach, however, where we were surprised to not get the last approval we needed for our beachfront 522 unit multifamily project. We are now exploring what other paths are available to us but nothing is clear at this point.

Let me also give a quick litigation update. We had some not great news on the Hammons loan with the borrower filing bankruptcy and choosing not to pay us interest on the loan during the preceding. While the borrower states they have substantial net worth approaching $1 billion, more than sufficient to pay our recourse loan in full under most scenarios, multiple litigations involving the Hammons estate created enough uncertainty that they decided to file. We will continue to press for resolutions that protect our interest.

On the positive side, we had good news in Chicago where after seven years we resolved several outstanding issues and can now take control of the development site previously known as the Mandarin Oriental site. With this resolution we can now explore all opportunities for realizing the value of this property.

Lastly, as you know we had received a sizable judgment in our favor on the Bevard litigation. The award was appealed and a hearing in the 4th District Court of Appeals was scheduled for the end of October. We learned right before the court date that due to an unfortunate circumstance opposing counsel could not appear, and so the case has been postponed further. We continue to be hopeful that our judgment will be upheld and this eight-year case will be put to rest.

With that let me turn it over to Geoff. Geoff?

Geoff Jervis - *iStar Financial Inc. - COO & CFO*

Thank you, Jay, and good morning everyone. Since joining iStar in June I've had the opportunity to speak with a number of debt and equity investors and have discussed our disclosures and ways that we can clarify and simplify the iStar story. To that end, last quarter we made several changes to our earnings release based in large part upon these conversations and in this morning's announcement we further enhanced our disclosures in ways that we think investors will find helpful.

We recognize that our portfolio is complicated and rest assured that we are by no means done. We will continue our regular dialogue with stakeholders and will strive to continuously improve our communications. In two weeks Teresa, Jason and I will be at NAREIT in Phoenix and we look forward to seeing many of you in person and receiving direct feedback on our efforts.

With that let's jump into the quarter's results.

Results for the quarter was strong with net income and adjusted income coming in at $0.44 and $0.47 per share respectively. As was the case last quarter, and consistent with our stated business plan to monetize these assets, results were driven by gains from the sale of operating properties and land and development assets. In total, with these two segments we realized $59 million of gains this quarter.

On an administrative note, last quarter we modified the definition of adjusted income to include charge-offs on previously impaired loans. This quarter the impact of the definitional change was a reduction of $8 million as compared to adjusted income under the old definition.

It is important to note that these charge-offs have already been realized in our GAAP financial statements in prior periods and are specific to our legacy loan portfolio. More about that later. Before these charge-offs this quarter's basic and diluted adjusted income would have been $0.81 and $0.54 respectively.

Switching to investment activity, during the quarter we originated $301 million of new investments comprised of $83 million of new loans, and $218 million of new net lease investments. This is also consistent with our stated business plan to invest the proceeds from the monetization of non-core assets into our primary loan and net lease business lines. Year to date we have originated $459 million of new loans and net lease investments.

During the period we funded $166 million of capital into a combination of new and previously originated investments as well as ongoing developments bringing year-to-date fundings to $461 million. On the repayment side we realized $262 million of sales and repayments during the quarter and $855 million year to date.

Ultimately, investments and fundings will exceed sales and repayment activity. However, the high volume of sales this year has created a net reduction in invested assets.

We continue to ramp up originations and our pipeline for new investments is large and growing. Our pipeline will continue to grow as we continue to dedicate more of the Company's human capital to originating loans and net lease opportunities as the operating property and eventually the land and development portfolios wind down.

Over to the portfolio. Our portfolio of investment assets stands at $4.8 billion comprised of our core assets, real estate finance and net lease, as well as our operating properties and land and development. The real estate finance portfolio was $1.7 billion at quarter end, generating $14 million of segment profit.

This quarter we have started to provide additional disclosures in our earnings release, breaking out our portfolio into two categories: Legacy loans made pre-2008 and iStar 3.0 loans made during and after the financial crisis. Most of our loans, $1.4 billion or 83%, are iStar 3.0 loans. These loans were 100% performing and generated a yield of 9%.

Our legacy loans represent the remaining 17% of the real estate finance portfolio with a $287 million balance net of reserves. These legacy loans were 77% non-performing. While this subportfolio has continued to shrink over the past several years, down from several billion dollars, as we have said it remains noisy.

Specifically, as Jay described, this quarter one loan, a $146 million loan secured by a portfolio of hotels, was designated as non-performing after the borrower and its related entities filed for bankruptcy and made the decision not to pay interest. Upon the borrower's bankruptcy filing we analyzed the loan carefully and while we believe that our loan is appropriately collateralized and that in most cases we will recover 100% of our investment, in light of the uncertainties of the litigation we chose to write the loan down by $12.5 million.

As this investment is in litigation we are unable to give further details at this time. However, as the process progresses, we will update the market as appropriate.

Looking at the reserves in aggregate, our total reserves, comprised of our general reserve and asset-specific reserves, decreased by $15 million. General reserves declined by $15.8 million as the performing loan portfolio credit profile improved in part due to the aforementioned hotel loan being reclassified as non-performing. Specific reserves rose by $800,000 due to the addition of the hotel loan and its attendant $12.5 million reserve offset by recoveries due to the progress we have made primarily on the Chicago land loan.

Our net lease portfolio balance was $1.5 billion at quarter end comprised of $1.36 billion of wholly-owned investments and $103 million equity investment in our net lease JV. As many of you know, our current net lease investment activity is primarily dedicated to our $500 million equity capital joint venture in which we share a 52/48 partnership with a single sovereign investor. The JV carries approximately 2 to 1 leverage and this quarter our JV funded $69 million of equity of which we funded approximately $35 million.

In addition, we sold a select few wholly-owned net lease assets this quarter most of which were located in Northern California for $78 million in proceeds and recognized a $7 million net gain. These sales represent an opportunity to take advantage of leasing and occupancy gains.

Yield on our overall net lease portfolio was 8.2% in Q3 and our occupancy of weighted average lease term were 99% and 14.6 years respectively. The net lease segment recorded profits of $19 million during the period.

This quarter there was a torrent of activity in our operating portfolio. Not only did we receive $86 million of proceeds from operating property sales and recorded gains of $28 million but also we continued to migrate the character of the remaining assets into more stabilized ready-for-monetization shape.

At 9/30 the portfolio was comprised of 29 assets with a gross book value of $530 million. We divide the portfolio into two categories: commercial and residential. Our residential portfolio consists of 58 unsold condos with a balance of $101 million. This subportfolio is nearly liquidated after having sold nearly $1.3 billion of residential real estate and realizing gains on sale of nearly $300 million.

The commercial portfolio has also come a long way. Today approximately 60% of the portfolio is classified as stabilized with only $185 million of assets classified as transitional. One year ago the percentages were very different, with 80% of portfolio classified as transitional and 20% as stabilized.

The good news is the progress we have made. The bad news is that this well of gains on sale will also soon run dry.

Our land and development portfolio had a balance of $1.1 billion at quarter end, roughly unchanged from last quarter and last year in terms of carrying value. That said, the activity within the portfolio has been and continues to be immaterial. While the top-line balance of this portfolio has not changed in a year the character of it has.

We have either sold or transferred completed a projects with a value of $187 million over the last 12 months and we have invested $129 million into the development of the remaining properties. That said, the portfolio is materially different from a year ago. Not only have we monetized and migrated over 15% of the portfolio but also we have progressed the remaining land and development portfolio towards the goal of monetization.

On the right-hand side of the balance sheet we remain flush with liquidity as our cash and available borrowings stood at approximately $800 million at quarter end, $940 million as of today. And we remain comfortably inside our leverage target of 2 to 2.5 times debt to equity.

In the fourth quarter our two convertible note securities with an aggregate balance of $378 million, originally $400 million reduced by open market purchases we conducted this quarter, mature and we are planning on retiring these securities with cash. One of the tranches, representing roughly half of the securities, has a conversion price of $11.77 and may be in the money as of the November 15 maturity date. In that case, we will find alternative uses for the cash we have earmarked for the repayment.

As we look forward we expect to continue to capitalize on our improving posture with banks and the debt capital markets in advance of our $925 million of maturities in 2017. And we expect to make progress on that front before year end. In 2015 and 2016 Michelle MacKay and her team increased our footprint in both the unsecured and term loan markets and we will capitalize on her efforts going forward.

Before I turn it back to Jay I wanted to spend a moment giving a state of affairs update on our business plan and point out the successes we have had and the remaining challenges in delivering on that plan. I'd like to think of our business plan as a three act play. The first act was the monetization of our residential operating portfolio and we have done what we said we would do, bringing the portfolio down from $1.3 billion of residential real estate to approximately $100 million at quarter end. Act two is the monetization of our commercial operating properties and we have sold $256 million in the last 12 months and stabilized all but 40% of the remaining portfolio.

The third act, and admittedly the most difficult, is it the monetization of our land and development portfolio. To that end, we have made progress in terms of selling and completing projects and we have positioned ourselves to monetize more of the portfolio over the next several years, having invested well over $300 million of CapEx since the beginning of 2013.

Our goal is to not only continue to monetize these assets but also to put the proceeds from those sales back into our core real estate finance and net lease businesses. The net result will be an iStar with an income statement dominated by recurring income from core assets and we look forward to delivering that vision.

Part of that vision will be aided by our continued progress in the capital markets and with our cash position. As we move forward we expect to realize on the fruits of our labor and our cost of debt and the structure of our liabilities. As we make progress on this front we will continue to migrate away from large inefficient cash balances. Both of these factors will materially help our performance.

Finally, in 2017 we will address our operating costs and attempt to find earnings growth from an expense rationalization. From a guidance standpoint we gave the market guidance that we would grow adjusted income by 50% from the $0.81 per share we reported in 2015. Through nine months we have delivered $1.06 per share of adjusted income, $1.17 per share with definitional consistency.

Looking forward we expect the fourth quarter to be slow on the sales front as we have picked a lot of fruit in Q2 and Q3. For the full year our internal models have us meeting our guidance under admittedly complex set of assumptions. While we forecast a slowdown in sales in Q4 we anticipate that the pace of sales will pick back up next year and we'll give full-year guidance on our year-end earnings call.

With that I will turn it back to Jay.

Jay Sugarman - *iStar Financial Inc. - Chairman & CEO*

Thanks, Geoff. Just a final comment on the markets.

There's an interesting tug-of-war going on in the real estate markets. There's concerns about global volatility, interest rates and the election all temper enthusiasm to deploy capital while the hard asset inflation-friendly nature of real estate cash flows continue to drive more money to look at the sector as an attractive alternative. We like a market with conflicting viewpoints but things are becoming a little more interesting across most of our disciplines and we look forward to finding some interesting places to invest in the next few quarters.

With that, operator, let's go ahead and open it up for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Jade Rahmani, KBW.

Jade Rahmani - *Keefe, Bruyette & Woods - Analyst*

Good morning. As a follow-up to your view on the market, do you think the markets are overly frothy right now or there is a healthy degree of caution in terms of underwriting?

We've seen the pace of transaction volumes slow, for example, and I think that we're hearing about fewer participants on bid lists for deals. Just want to get your view on the current state of the market and also if you think 2017 is likely to be more of the same sort stability or if you anticipate increasing pockets of frothiness or concern?

Jay Sugarman - *iStar Financial Inc. - Chairman & CEO*

It's interesting, I will tell you the overarching sense we have is people want to invest but they are being held back by things, the uncertainty around the rates, uncertainty around the election. I think if there is no untoward surprises I think 2017 you will see more money flow into real estate.

Yes, there is a couple of frothy areas that are going to cool down. But overall I think the nature of the cash flows, again as I said the hard asset inflation-friendly nature of them, is actually a great place on a relative value basis to invest right now.

So I don't see a wholesale pullback. I just see some temporal uncertainty that has to go away, but there's a lot of money on the sidelines that still wants yield, there's a lot of money that still wants inflation protected cash flows. And when you stack it up against a lot of other things, real estate in most places still looks pretty attractive.

Jade Rahmani - *Keefe, Bruyette & Woods - Analyst*

And can you put some specifics around where you are seeing the most attractive incremental investment opportunities and maybe how those compare with your internal investment opportunities on CapEx?

Jay Sugarman - *iStar Financial Inc. - Chairman & CEO*

Look, the big secular trends are the banks are pulling back to the things they are best at and they are leaving big parts of the market open for new players. We've always focused on more custom tailored bespoke-type opportunities. Those are clearly going to be where we spend most of our time.

And that market I think, frankly, is getting bigger, not smaller. But there's more people trying to play in that market, so there's still competition but we certainly think we are going to get our fair share and we think the market opportunity is actually growing, not shrinking.

Relative to what we see in our own book, there's a little bit of push and pull, the stuff in our own book is obviously 100% probability, so we can be very efficient with resources. We control most of the variables around it. We have better, obviously, insight into the dynamics because we've worked those assets for a long time.

I would say at the beginning of the year and through the middle of the year some of the legacy stuff was the highest and best use of our capital. As Geoff said I think we are beginning to turn more towards investing some of our cash outside the existing portfolio and we are starting to see some interesting things in the net lease market again. So I'm hopeful that while we still see some really interesting proprietary opportunities in our own book we think the external environment has gotten better over the last quarter and we see some, obviously, longer-term dynamics with risk retention rules and some other systemic reasons why the finance market should be and remain interesting to us.

Jade Rahmani - *Keefe, Bruyette & Woods - Analyst*

And are there any new investment strategies or asset classes you're exploring, for example on the lending side perhaps using secured financing to do more senior first mortgages or anything in that vein?

Jay Sugarman - *iStar Financial Inc. - Chairman & CEO*

Always, Jade. You know we are always coming up with new stuff.

We are seeing some pockets that are intriguing to us that we are going to try to see if there is real opportunity can they be scaled. We are not going to tell you about it, that right now. But we are actively working on things that we think are very interesting risk reward sectors of the market.

Jade Rahmani - *Keefe, Bruyette & Woods - Analyst*

In terms of 2017 I know you said that next quarter you'd probably provide guidance, but just directionally with the converts if at least one of them settles in cash or perhaps both that will materially reduce diluted share count, would you anticipate meaningful earnings growth next year?

Jay Sugarman - *iStar Financial Inc. - Chairman & CEO*

I think you point out one of the things we focus on which is a lower share count will magnify the value of some of the things we hope to be able to achieve next year. I don't think we are quite ready to give you guidance but, obviously, we think the benefits that are being worked on inside the portfolio could have a nice impact on earnings. But let us have a little more clarity before we come to you with a number.

Jade Rahmani - *Keefe, Bruyette & Woods - Analyst*

In terms of loan repayments what do you expect for the fourth quarter and 2017? Amongst some of the other finance REITs that have reported we have seen a trend of elevated loan repayments.

Jay Sugarman - *iStar Financial Inc. - Chairman & CEO*

That is something that's going on. You can see from the yield on our performing loan portfolio in the 3.0 category they are pretty attractive.

So when borrowers achieve their business plans they will go back to market, try to tap a more commodity-like capital. But we don't really have a firm number that we are focused on. We know it is going to be in the hundreds of millions probably for each of the next couple of quarters.

Jade Rahmani - *Keefe, Bruyette & Woods - Analyst*

In terms of liquidity, assuming you do repay the November convert maturities, how would you characterize your liquidity post that event and sources of capital available to you? Do you anticipate enough loan repayments and proceeds from asset sales to still be in a strong cash position?

Geoff Jervis - *iStar Financial Inc. - COO & CFO*

Hi, it's Geoff. So with respect to liquidity, right now we have $900 million of cash and availability under the revolver. And so if we take out the converts with roughly $400 million of cash obviously we will still have significant liquidity.

As a matter of fact, as I alluded to in my script, I think we are looking for ways to increase our revolving capability as well as ways to get money out the door so that we now that we've passed through the storm, so to speak, that we don't live with such high cash balances. But for the time being we are flush with cash, and I think that some of the stuff we are working on today, as well as our capital markets plan for next year, is something we are very comfortable with in addressing unfunded commitments as well as maturities.

Jade Rahmani - *Keefe, Bruyette & Woods - Analyst*

And just finally on CapEx, can you say how much you think would be reasonable to expect you to spend in 2017 on the land and operating property side or perhaps provide a range?

Geoff Jervis - *iStar Financial Inc. - COO & CFO*

We don't have a bad number right in front of us. I think in the land portfolio we are looking at somewhere in the range of $200 million with half of that in Asbury and then in the operating portfolio about half that.

Jay Sugarman - *iStar Financial Inc. - Chairman & CEO*

There's some assumptions in there about projects we go vertical on and how we finance them or don't finance them. So we are refining that in our business plan process that we are going through right now.

Jade Rahmani - *Keefe, Bruyette & Woods - Analyst*

Thanks for taking my questions.

Operator

Steve DeLaney, JMP Securities.

Steve DeLaney - *JMP Securities - Analyst*

Thanks, good morning, and I appreciate you taking my questions. Picking up on the debt side as far as new opportunities, as we look at the market it seems like there are a dozen people lined up to make senior floating rate bridge loans on transitional properties whether it's institutional or middle-market. It just seems like a lot of capital there.

Are you looking to be maybe more opportunistic and try to fill in where there are real gaps in the financing market to be more of a solutions provider? And I'm specifically referring to construction loans, because that's where we are hearing that there are gaps and with your development experience it seems like that would be a logical place for you to put some money to work. Thanks.

Jay Sugarman - *iStar Financial Inc. - Chairman & CEO*

I think you've kind of nailed it Steve. There is plenty of money looking to provide transitional short-term bridge loans which can be a very good business. We think there has been a little bit of a pullback in some of the aggressiveness, so those loans are looking fairly priced right now and in some cases attractively priced.

The construction market is a whole different kettle of fish. Different market, different skillsets needed, different efficiency profile about how the dollars go out the door. And certainly we have been a meaningful player in that market for a long time, continue to have our toes and fingers in that market.

We do see, again, a little bit of a separation between the people who have been in the business and are trustworthy and have really served their borrowers and their customers well. That's becoming more important. That's becoming more important than 50 basis point difference in pricing.

People want to know you're going to be there, people want to know that you are problem-solving, people want to know that you are going to be with them from the beginning all the way to the end. And so the ability to provide that kind of capital, provide that kind of relationship is a big competitive advantage that we do try to exploit. That market definitely has gotten more interesting and more favorably priced both in terms of just coupons but also just the structure and the dynamic.

We are seeing borrowers who absolutely are picking their lenders based on what they know reputationally about how they act and how they perform. And so we've been really pointing to our long history of helping find ways to create value both inside the existing envelope and when new opportunities come up. As an on-balance sheet lender that really does everything in-house we can be very flexible, very nimble and really help them capture more of the value chain than some of the lenders who don't have those capabilities.

Steve DeLaney - *JMP Securities - Analyst*

Yes, that's great color, Jay. Helpful.

And just one more if I may. The stock has done well here recently. I think STAR is up about 10% since June 30. But I look back, it's still down 10% year to date.

So how are you thinking these days about share buybacks as you look to allocate capital into new investments or existing? Where do buybacks stack up in your view of your capital allocation?

Jay Sugarman - *iStar Financial Inc. - Chairman & CEO*

Look, I think you've seen us be fairly aggressive in the past. When we've had capital and we look across the choices it often was the best relative value. But certainly not long term what we think the growth path of the Company will be based on.

We are starting to see the markets open up and get more interesting for new investments. So I'm hoping that opportunity set getting bigger will give us some interesting choices. But by retiring the converts we take a big chunk out of the diluted share count and when the stock is undervalued we have shown in the past that we are an aggressive buyer.

Steve DeLaney - *JMP Securities - Analyst*

Great, I appreciate the comments this morning. Thank you.

Operator

Mr. Fooks, we have no further questions in queue.

Jason Fooks - *iStar Financial Inc. - VP, IR & Marketing*

Thanks, John. Thanks to everyone for joining us this morning. If you should have any additional questions on today's earnings release, please feel free to contact me directly.

John, would you please get the conference call replay instructions once again? Thanks.

Operator

Certainly. Once again, Ladies and gentlemen, this conference is available for replay. It starts today at 12 p.m. Eastern, will last until November 17 at midnight.

You can access the replay at any time by dialing 800-475-6701 and entering the access code 403997. That number again, 800-475-6701, access code 403997.

That does conclude your conference for today. Thank you for your participation. You may now disconnect.